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## Danish securitisation and structured finance: from traditional mortgage bonds to EU regulated covered bonds

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The traditional Danish market for mortgage bonds issued by Danish mortgage credit institutions (including Danish Ship Finance) remained active throughout 2007 and into 2008. The Danish mortgage bond market remains one of the largest in Europe based on value, turnover and number of issues.

The vast majority of mortgage bond issues are based on mortgages in properties; bonds issued by Danish Ship Finance, which are backed by mortgages registered in merchant vessels, accounted for less than €4 billion in 2007. Special mezzanine mortgage-backed bonds suffered a setback with only one issue since January 1 2007.

Alongside mortgage-backed bonds, there have been a few other transactions based on other asset classes.

### **Mortgage bonds: covered bonds**

The traditional Danish mortgage bond market dates back to 1795 when a large fire destroyed a part of Copenhagen. This led to the foundation of the first Danish mortgage credit association. Over the following years, further associations were founded and the authorities eventually regulated the area extensively. Today, mortgage institutions are supervised by the Danish Financial Supervisory Authority (FSA). Under traditional mortgage bond legislation, the rights of the bond holders are safeguarded by a statutory ring-fencing. Thus, if the mortgage credit institution becomes insolvent or is otherwise unable to pay its debts, the bond holders will rank first in

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regard to the assets of the relevant mortgage credit institutions, including the underlying pool of mortgage deeds.

Only a licensed mortgage credit association can issue bonds under the traditional legislation originating from the 19th century. Until recently, the bonds could be issued without an underlying offering circular and none of the bond issues were rated. It has also surprised some international investors that most of the existing mortgage bonds can be redeemed at par, even if the interest rate of the bond is fixed for a 30-year period.

In 2007 the Danish Parliament introduced new legislation in respect of covered bonds in order to implement the provisions of the EU Capital Requirements Directive (2006/48/EC and 2006/49/EC).

In principle, the new rules should work as a supplement or an alternative to the existing mortgage bond legislation. However, the existing types of mortgage bond do not qualify as covered bonds under new EU rules. Any mortgage credit institution which wishes to benefit from the attractive risk-capital charge of the new covered bonds would thus have to set up a covered bonds programme. So far, a substantial number of mortgage credit institutions have chosen to do so, although they have also chosen to retain the existing mortgage bonds programmes for the time being. It remains to be seen whether the new covered bonds will eventually squeeze out the traditional mortgage bonds.

The introduction of the new covered bond legislation has also led to changes regarding which institutions can issue mortgage-backed bonds. Traditionally, banks have been unable to issue mortgage bonds themselves and have thus only been able to access the mortgage bond market through subsidiaries or affiliated companies, such as mortgage credit institutions. However, this has changed with the new covered bond legislation, which will also enable banks to issue covered bonds. Interestingly, Danske Bank A/S acts as issuer on a recent €15 billion global covered bond programme rather than its subsidiary, Realkredit Danmark A/S, one of the larger mortgage credit institutions.

Banks and mortgage credit institutions which intend to issue covered bonds must apply to the FSA for permission. If granted, the financial institution must establish a cover pool of assets with a value corresponding to the aggregate value of the covered bonds to be issued. In theory, this principle should safeguard the bondholders from any credit risk on the bonds.

The value of the cover pool will be monitored continuously. If it falls below the value of the outstanding bonds, the financial institution will have to inject additional qualifying assets into the cover pool. If the financial institution does not do so, its bonds will lose their status as covered bonds.

If the financial institution becomes insolvent, the covered bonds and the cover pool are taken into administration by an administrator independent of the bankrupt estate. The bondholders will thus have a first-priority claim against the assets of the cover pool. The bankruptcy estate does not include the remaining assets until the costs of the administration and the claims of the bondholders have been satisfied in full.

In general, thus far the international financial crisis of 2007/2008 has had a relatively limited impact on the Danish bond market. This is most likely due to the fact that approximately 80 per cent of the investor base is Danish. However, market maker arrangements on some bonds were suspended for one day as the difference between the offered sales price and purchase price became too large.

#### **Junior mortgage backed-bonds**

Since 2003 junior mortgage-backed bonds have been the second biggest class of asset-backed securities listed on the Copenhagen Stock Exchange after mortgage bonds (based on properties and ships). However, there was only one issue in 2007 and there have been none so far in 2008.

This development has mostly been a result of the prevailing property market conditions. However, regulatory challenges may also have had an effect on issuers' interest.

Such bonds have usually been used to finance the mezzanine part of purchase sums on large property portfolios in Sweden or Germany with Danish interests holding the equity.

The popularity of such bonds can partly be ascribed to investors' appetite for high-interest and fixed-income products with an exposure to real property. During 2006 and 2007, the issuers experienced a reduced gap between the yield on the targeted properties on the one side and interest rates for senior financing on the other. Simultaneously, there was greater interest among investors to obtain a greater stake in the potential upside on the relevant properties. This led to a reduced interest on the bonds.

Since 2007 there has been a gradual shift from the issuance of junior mortgage-backed bonds towards a greater reliance on equity for the financing of property acquisitions. In some cases a share class has been offered in public with limited voting powers but a budgeted dividend equal to 5 per cent of the investment. In reality, relevant shareholders have a position comparable to that of some types of bondholder.

Almost one-third of the bonds issued from 2003 until now have been redeemed due to the sale or restructuring of the ownership to the relevant properties. In most cases redemption has taken place above par due to pre-payment before the due date. This had led to an effective yield of around 20 per cent for some bonds issues.

#### Other asset classes

Other asset-backed bonds present on the Danish market include collateralised bond obligations (CBOs) and collateralised loan obligations (CLOs). The former are primarily investor-driven products that are typically exposed to stock market indexes and/or credit risks. The demand for such products seems to be in decline, at least in relation to listed CBOs.

In relation to CLOs, HSH Nordbank AG in Copenhagen continues to arrange the issue of bonds based on repackaged tier-two capital from a number of

small and medium-sized local and regional Danish banks under the ScandiNotes name. Similar business has also been conducted recently by SPV Kalvebod Plc, which was set up by Nykredit A/S, and Amalie No 1, which was set up from the United Kingdom.

The first four issues of ScandiNotes were issued by a protected cell company in Guernsey in the period from 2002 to 2006 and listed on the Copenhagen Stock Exchange. The latest issue, in December 2007, was carried out by an Irish special purpose vehicle and listed on the Irish Stock Exchange. The principal and interest of the Class B and Class C notes were guaranteed by the European Investment Fund, which was also a new step.

At the other end of the scale, in 2007 the Danish market saw one further fully fledged receivables securitisation involving loans to Danish consumers. However, the receivables were sold to an offshore special purpose vehicle and thus the notes issued to fund the transaction were not listed on any stock exchange.

#### Regulatory challenges

In recent years securitisation and other forms of structured finance have been increasingly scrutinised by the FSA. In particular, the basic set-up of a junior mortgage-backed bond scheme has attracted the attention of the FSA, which now – as a starting point – requires that the issuer SPV obtain a banking licence.

Under a traditional junior mortgage-backed bond scheme, the property company which intends to purchase the property portfolio in question will set up an SPV to issue the bonds. The proceeds from the bond issue are then lent to a subsidiary of the SPV, which acquires and holds the relevant properties. The subsidiary issues a mortgage on the property in favour of the issuer SPV as security for the inter-company loan.

Recent administrative practice from the FSA seems to suggest that, at least in some circumstances, the FSA will be of the opinion that the bond issue, together with the re-lending of the funds to another company for the purposes of the Financial Business Act, qualifies the SPV as a bank and thus requires the SPV to obtain a banking licence.

When deciding whether an issuer SPV needs to be licensed, recent administrative practice provides (contrary to earlier practice) that the FSA now applies a four-step test:

- Does the undertaking receive deposits or other repayable funds?
- Does the undertaking receive its deposits or funds from the public?
- Does the undertaking grant loans on its own account?
- Are these activities a significant part of the operations of the undertaking and/or are they of a commercial nature?

If all four criteria are met, the SPV is deemed to be a bank and requires a banking licence. If only the first, second and fourth criteria are met, the SPV will most likely be a savings institution and will need a savings institution licence. In all other circumstances, the SPV is not required to be licensed under the Financial Business Act.

In relation to the first criterion, it can be argued that bonds would qualify as repayable funds, but this does not necessarily imply that the SPV issuing the bonds would qualify as a bank. The EU Credit Institutions Directive (2006/48/EC) seems to indicate that only entities that issue bonds on a continuous basis might qualify as a credit institution. The FSA, however, seems to disregard this indication in its administrative practice.

In respect of the second criterion, it is hard to see that the special purpose vehicle is deposit taking and/or that receipt of funds from the public includes the investment in bonds with a face value of more than €50,000 and/or the private placing of bonds.

Whether an undertaking is deemed to have granted loans on its own account depends on the case in question. However, the FSA seems to promote a wide interpretation of this criterion, effectively leading to a situation where almost every transfer of funds to a third party which are to be repaid will be considered as a loan

for the purposes of the Financial Business Act. It seems to make no difference to the FSA whether the loan is granted to a subsidiary or is otherwise an intra-group loan.

Finally, in relation to the fourth criterion, the FSA is of the opinion that the deposit-taking and/or funding activities of an undertaking form a significant part of the activities of the undertaking and/or are of a commercial nature if the funds are not invested directly in the issuer's main business activities and account for a significant part of the issuer's liabilities. In a recent book FSA representatives stated that 'significant' should be interpreted to mean 25 per cent or more of the issuer's liabilities.

In applying this test, the FSA takes neither the business activities nor the total liabilities of the group into account. The FSA looks only at the activities and liabilities of the issuer company. There are no provisions in the Danish legislation that support the FSA's view. On the contrary, most corporate holding companies that issue bonds would most likely refer to the general business of the group as their most significant activity rather than the issue of bonds.

An FSA guidance statement of October 30 2007 stated that at least two issuers chose to appeal FSA decisions based on the above interpretation. Although the appeals have been pending for some time with the Business Appeal Panel, the parties are still awaiting the decisions.

When facing these regulatory challenges, a number of issuers opted for transaction structures that do not trigger the licence requirements under the new and even stricter regulatory requirements.

The FSA gives one example in the guidance statement: in this case, a Danish bank arranged the issue of bonds from an Irish special purpose vehicle and the bonds were listed on the Irish Stock Exchange. The bonds were sold by the Danish bank to banks, institutional investors and large private foundations. As the bonds were not offered to the public or listed in Denmark, the FSA found that it could not require the issuer to obtain a banking licence.

### Conclusion

The Danish market for asset-backed bonds remains strong, although the vast majority of the market is still comprised of bonds relating to real estate. There has been a shift from traditional Danish mortgage bonds to covered bonds based on the EU rules.

Apart from property-related transactions, it is difficult to foresee further growth under the current market conditions.

To date, the issue and offering of bonds by issuers on the local stock exchange may have been limited by the FSA's new administrative practices, but this is unlikely to continue in the long run.